

**Letter of Findings Number: 04-20140027**  
**Use Tax**  
**For Tax Years 2010, 2011, and 2012**

**NOTICE:** IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective as of its date of publication and remains in effect until the date it is superseded by the publication of another document in the Indiana Register.

**ISSUE**

**I. Use Tax – Manufacturing Exemption.**

**Authority:** IC § 6-2.5-2-1(a); IC § 6-2.5-3-2(a); IC § 6-2.5-3-4; IC § 6-2.5-5-1 et seq.; IC § 6-2.5-5-3; IC § 6-2.5-3-6(b); IC § 6-8.1-5-1(c); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Rhoades v. Indiana Dept. of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); Ind. Dept. of State Revenue v. AOL, 963 N.E.2d 498 (Ind. 2012); Indiana Dept. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983); Department of Revenue v. Kimball International, Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); Indianapolis Fruit Co. v. Dept. of State Revenue, 691 N.E.2d 1379 (Ind. Tax Ct. 1998); Ind. Dept. Rev. v. RCA, 310 N.E.2d 96 (Ind. Ct. App. 1974); General Motors Corp. v. Ind. Dept. of State Rev., 578 N.E.2d 399 (Ind. Tax Ct. 1991); [45 IAC 2.2-2-1](#); [45 IAC 2.2-3-4](#); [45 IAC 2.5-5-8](#).

Taxpayer protests the imposition of use tax on purchases of computer hardware, computer software, labels, and ink asserting that such purchases are exempt from use tax.

**STATEMENT OF FACTS**

Taxpayer is an Indiana corporation. Taxpayer manufactures plastic components through a thermoforming process. During an audit, the Indiana Department of Revenue ("Department") proposed assessments of base tax, interest, and penalties on computer hardware, computer software, labels and ink. Taxpayer protests the proposed assessments. An administrative hearing was held, and this Letter of Findings results. Additional facts will be supplied.

**I. Use Tax – Manufacturing Exemption.**

**DISCUSSION**

After an audit, the Department issued proposed assessments of use tax on certain purchases of computer hardware, computer software, labels, and ink. Taxpayer protests the assessment asserting that such purchases are exempt from use tax.

All tax assessments are prima facie evidence that the Department's claim for the tax is valid, and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). The issue before the Department is whether Taxpayer met its burden to prove the Department's assessment is incorrect.

Indiana imposes a sales tax on retail transactions made in Indiana. IC § 6-2.5-2-1(a); [45 IAC 2.2-2-1](#). Indiana imposes a complementary use tax on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction" regardless of the merchant's or transaction's location. IC § 6-2.5-3-2(a); [45 IAC 2.2-3-4](#). The use tax is "functionally equivalent to [the] sales tax." Rhoades v. Indiana Dept. of State Revenue, 774 N.E.2d 1044, 1047-48 (Ind. Tax Ct. 2002). "Indeed, the purpose of the use tax is merely to prevent evasion of the sales tax." Ind. Dept. of State Revenue v. AOL, 963 N.E.2d 498, 501 (Ind. 2012). The person who uses, stores, or consumes property acquired in a retail transaction in Indiana is responsible for payment of use tax on the transaction. IC § 6-2.5-3-6(b).

Taxpayer concedes that the computer hardware, computer software, labels and ink were acquired in retail transactions, but argues that such transactions were exempt from tax. Retail transactions ordinarily subject to use tax will be exempt if sales tax was paid at the point of purchase. IC § 6-2.5-3-4; [45 IAC 2.2-3-4](#). The legislature also provided specific exemptions from sales or use tax. IC § 6-2.5-5-1 et seq. Exemption statutes are strictly construed in favor of taxation. Indiana Dept. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520, 524 (Ind. 1983). Whether a taxpayer qualifies for an exemption from tax is "highly fact sensitive," and it is the taxpayer's burden to prove the exemption criteria has been met. Department of Revenue v. Kimball International, Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

Taxpayer argues that the purchases of computer hardware, computer software, labels and ink are exempt because they "are directly related to [Taxpayer's] manufacturing process . . . ." Generally, "all purchases of tangible personal property by persons engaged in the direct production [or] manufacture . . . of tangible personal property are taxable." [45 IAC 2.5-5-8\(a\)](#). However, "transactions involving manufacturing machinery, tools, and equipment are exempt" if they are purchased for "direct use in the direct production [or] manufacture . . . of other tangible personal property." IC § 6-2.5-5-3(b); [45 IAC 2.5-5-8\(a\)](#).

To claim this exemption, a taxpayer must first demonstrate that it produces tangible personal property, as it is clear that "without production there can be no exemption." *Indianapolis Fruit Co. v. Dept. of State Revenue*, 691 N.E.2d 1379, 1384 (Ind. Tax Ct. 1998).

Second, a taxpayer must show that the property was acquired for the "direct use in the direct production [or] manufacture . . . of other tangible personal property." IC § 6-2.5-5-3(b). Courts have recognized that the legislature's "repetition of the requirement that the use be direct" was intended to provide for a narrow construction of the exemption. *Ind. Dept. Rev. v. RCA*, 310 N.E.2d 96, 100 (Ind. Ct. App. 1974). Therefore, to be considered directly used in direct production or manufacture, the property must be "an essential and integral part of an integrated process that produces tangible personal property." *Kimball*, 520 N.E.2d at 457; [45 IAC 2.5-5-8\(c\)](#). Whether property is essential and integral to an integrated process is determined "by identifying the points where production begins and where it ends." *Indianapolis Fruit*, 691 N.E.2d at 1384. For the purposes of this exemption, the production process "begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required." [45 IAC 2.2-5-8\(d\)](#); See *General Motors Corp. v. Ind. Dept. of State Rev.*, 578 N.E.2d 399 (Ind. Tax Ct. 1991) (stating that "An integrated production process terminates upon the production of the most marketable finished product, e.g., the product actually marketed.").

Property may be essential and integral to an integrated production process without actually transforming the composition of the tangible personal property being produced. *Cave Stone*, 457 N.E.2d at 524. Also, property may not be essential and integral to an integrated production process even though it is "considered essential to the conduct of the business of manufacturing." [45 IAC 2.2-5-8\(g\)](#). Property used for quality control which is an essential and integral part of an integrated production process is exempt. [45 IAC 2.2-5-8\(i\)](#) Example. However, property used in non-operational activities is not an essential and integral part of an integrated production process and thus not exempt. [45 IAC 2.2-5-8\(j\)](#).

#### A. IQMS Software, Cisco Network Switch, Dell Server

Taxpayer concedes that the IQMS Software, Cisco Network Switch, and Dell Server were purchased in retail transactions and used in Indiana. However, Taxpayer argues that at least a portion of the purchase price of each transaction is exempt from use tax because use of part of each item is "directly related to [Taxpayer's] manufacturing process . . . ."

It is undisputed that Taxpayer is producing tangible personal property, so the issue is whether Taxpayer has shown that the IQMS Software, Cisco Network Switch, and Dell Server are "essential and integral part[s] of an integrated process that produces tangible personal property." *Kimball*, 520 N.E.2d at 457; [45 IAC 2.5-5-8\(c\)](#).

##### 1. IQMS Software

The audit report states that IQMS Software is "used to accept orders, bill customers, various accounting functions, and to monitor the manufacturing process" and thus not exempt. Taxpayer asserts that part of the IQMS Software is used for exempt purposes.

The IQMS Software is made up of many different components, and Taxpayer is claiming an exemption for only three components of the total IQMS Software purchase: Shop Floor User, SPC, and RealTime. Shop Floor User is used to "log into a work order on the shop floor, monitor and report production, view documents, enter SPC data, print labels, create PM work orders and more." SPC is used to "enhance decision making and facilitate continuous improvement based on readily accessible SPC data analysis." RealTime Production Monitoring is used to monitor "the currently running product in real time" and "process data at the PLC level in real time, as it is happening on the plant floor . . . ."

Taxpayer explains that these three components of the IQMS Software allow a machine operator to analyze "the real time data to determine what adjustments need to be made to get the machine back within control limits." The Taxpayer asserts that "[t]he operator's ability to monitor the real time data through IQMS is critical in his effort to avoid making defective parts."

The Shop Floor User component of the IQMS Software is used outside the production process for non-operational activities like monitoring and reporting production, viewing documents, and printing labels. Shop Floor User is not "an essential and integral part of an integrated process that produces tangible personal property." *Kimball*, 520 N.E.2d at 457; [45 IAC 2.5-5-8\(c\)](#).

The RealTime Production Monitoring component of the IQMS Software is used to monitor "the currently running product in real time" and "process data at the PLC level in real time, as it is happening on the plant floor . . . . Additionally, the SPC component of the IQMS Software is used to "enhance decision making and facilitate continuous improvement based on readily accessible SPC data analysis." The RealTime Production Monitoring and SPC components of the IQMS Software are quality control software which is used throughout the production cycle to ensure that a marketable product is created. As they are used to monitor and adjust the whole production process for quality purposes, they are "an essential and integral part of an integrated process that produces tangible personal property." *Kimball*, 520 N.E.2d at 457; [45 IAC 2.5-5-8\(c\)](#) and (i). Because they are essential and integral parts of an integrated process that produces tangible personal property, the RealTime Production Monitoring and SPC components of the IQMS Software were acquired for "direct use in the direct production [or] manufacture . . . of other tangible personal property." IC § 6-2.5-5-3(b).

Taxpayer's protest is sustained regarding the RealTime Production Monitoring and SPC software components of the IQMS Software. (This includes items designated SPC, RT PROD MON, RT LICENSE, RT PM, RT PM ifF-GEN, and RT PM LICENSE on the IQMS Software Purchase Detail provided by Taxpayer for the administrative hearing.) Taxpayer's protest is denied regarding the Shop Floor User component of the IQMS Software. This results in a 38 percent exemption rate for the IQMS software purchase under protest.

**2. Cisco Network Switch and Dell Server**

The audit report states that the Dell Server "is used to store their recipes and manufacturing instructions for their production equipment" and the Cisco "[N]etwork [S]witch is used to access the information stored on the server." However, Taxpayer indicates that the IQMS Software is run through the Cisco Network Switch and Dell Server. Computer hardware which is used for both exempt and non-exempt purposes may be exempt to the extent the property is used for exempt purposes. See [45 IAC 2.2-5-8\(c\)](#) Example (7). In this case, the exemption extends to the Cisco Network Switch and Dell Server to the extent that they are directly used by the IQMS Software during the production process. RealTime Production Monitoring and SPC software components of the IQMS Software comprise 38 percent of the total purchase price of the IQMS Software. Therefore, 38 percent of the purchase price of the Cisco Network Switch and Dell Server is exempt. Taxpayer's protest is sustained regarding 38 percent of the purchase price of the Cisco Network Switch and Dell Server.

**B. Labels and Ink**

Taxpayer affixes labels to boxes containing their finished products. As described in the audit report, the labels are "used for shipping the product" and contain "the shipping address, the manufacturers [sic] address, bar codes for inventory tracking, part number, customer PO number, and any other requested information from the customer." There are second labels which "contain the shift number and date of manufacture." According to the audit report, the labels "do not qualify as wrapping materials, do not become an integral part of the product sold, and do not meet the necessary criteria to be exempt purchases for resale in the same form as they were purchased."

Taxpayer explains that these labels are used to "complete traceability from the original resin pellet to the final finished goods part that is installed on [Taxpayer's] customers [sic] products." The labels "are required by [Taxpayer's] customers," and Taxpayer argues that "even though they contain other 'administrative' data in addition to [Taxpayer's] traceability serial number, it is the serial number that becomes critical when [Taxpayer] must back track a part back to its original chemical content and how it was processed."

In this case, Taxpayer has not demonstrated that the labels are an integral part of its integrated production or manufacturing process. "The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean that the property 'has an immediate effect upon the article being produced'. Instead . . . the property must also be an integral part of an integrated process which produces tangible personal property." [45 IAC 2.2-5-8\(g\)](#). While the labels may be essential to the conduct of Taxpayer's business and required by its customers, the labels and ink used to print them is not an essential and integral part of an integrated production process. Taxpayer's protest is respectfully denied regarding the labels and ink.

**FINDING**

Taxpayer's protest is sustained regarding the purchase price of the RealTime Production Monitoring and SPC software components of the IQMS Software. (This includes items designated SPC, RT PROD MON, RT LICENSE, RT PM, RT PM ifF-GEN, and RT PM LICENSE on the IQMS Software Purchase Detail provided by Taxpayer for the administrative hearing.) Taxpayer's protest is respectfully denied regarding the purchase price of the Shop Floor User component of the IQMS Software. Taxpayer's protest is sustained regarding 38 percent of the purchase price of the Cisco Network Switch and Dell Server. Taxpayer's protest is respectfully denied regarding the remaining 62 percent of the purchase price of the Cisco Network Switch and Dell Server. Taxpayer's protest is respectfully denied regarding the labels and ink.

*Posted: 05/28/2014 by Legislative Services Agency*  
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